United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-7428

ORIGINAL

In The

United States Court of Appeals

For The Second Circuit

B

P/S

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM,

Plaintiffs-Appellants,

-against-

EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F.I. duPONT GLORE FORGAN & CO. and duPONT GLORE FORGAN INCORPORATED,

Defendants,

and

HASKINS & SELLS and THE NEW YORK STOCK EXCHANGE, INC.,

Defendants-Appellees.

On Appeal from an Order of the United States District Court for the Southern District of New York.

UNITED STATES COURT OF APPEALS
FILED
JAN 17 1977
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

REPLY BRIEF ON APPEAL FOR PLAINTIFFS-APPELLANTS

SHEA GOULD CLIMENKO & CASEY
Attorneys for Plaintiffs-Appellants Howard C. Hirsch, Paul L. Kohns and Marshall S. Mundheim
330 Madison Avenue
New York, New York 10017
(212) 661-3200

SHELDON D. CAMHY
RICHARD L. SPINOGATTI
Of Counsel

(10142)

LUTZ APPELLATE PRINTERS, INC.
Law and Financial Printing

South River, N.J. (201) 257-6850 | New York, N.Y. (212) 563-2121 | Philadelphia, Pa. (215) 563-5587 | Washington, D.C. (202) 783-7288

TABLE OF CONTENTS

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM, Plaintiffs-Appellants,	:	
-against-	:	
EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I. duPONT & CO., F.I. duPONT GLORE FORGAN & CO. and duPONT GLORE FORGAN INCORPORATED, Defendants,	:	Docket No. 76-7428
-and-	:	
HASKINS & SELLS and NEW YORK STOCK EXCHANGE, INC., Defendants-Appellees.	:	

REPLY BRIEF OF PLAINTIFFS-APPELLANTS

Preliminary Statement

This brief is submitted in reply to the briefs of defendants-appellees Haskins & Sells and The New York Stock Exchange, Inc. on this appeal. For the convenience of the Court, references to the briefs on appeal of Haskins & Sells and The New York Stock Exchange, Inc. will be, respectively, as follows: (H&S Br. ___), (NYSE Br. ___). References to the Joint Appendix on appeal will be as follows: (_____a).

POINT I

THE FACTS NOT DISCLOSED TO HIRSCH, KOHNS AND MUNDHEIM WERE MATERIAL

A. General Discussion

The facts which were known to Haskins & Sells and to the New York Stock Exchange and which were not disclosed to Hirsch, Kohns and Mundheim were:

1. In December, 1969 Francis I. duPont & Co. ("duPont") created $6,000,000 of "capital" (of its total capital of $18,000,000) and $2,000,000 of income by selling for its own account and benefit securities whose ownership could not be determined from the books and records of the firm, and

2. By the aforesaid device, duPont's capital ratio, which had been determined to be in excess of 76,000% by the New York Stock Exchange as of September 28, 1969, the date of duPont's audit by Haskins & Sells, improved to slightly less than 2,000% and thus into compliance with applicable New York Stock Exchange rules and the federal securities laws by January, 1970.

At no time was either the outrageously violative capital ratio or the method by which it was "cured" disclosed to Hirsch, Kohns and Mundheim.

By any fair standard these facts must be deemed material to a subsequent decision to invest in duPont. There is

no question that a reasonable investor would have attached importance to such facts. A capital ratio in excess of 76,000% is, in and of itself, a staggering fact when it is considered that a ratio of over 2,000% violated both the Rules of the New York Stock Exchange and Section 8(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78h(b))* as it then provided. The fact that $6,000,000 worth of securities of unknown ownership had been sold and the case infused into duPont's capital obviously would create a doubt as to whether duPont even owned its capital.

The resort by duPont to the sale of securities of unknown ownership for capital would have disclosed more about its real capital position and its future ability to raise any additional capital than any other fact. No investor would have placed confidence in the expectation that duPont was able to raise additional capital in the future, if it were known that the firm had already gone to the extreme of selling securities of unknown ownership and using the proceeds for capital.

B. <u>The Argument that Hirsch, Kohns and Mundheim did Not Regard the Facts as Material.</u>

Haskins & Sells and the New York Stock Exchange have asserted that Hirsch, Kohns and Mundheim were interested only in duPont's capital situation immediately prior to the July 2, 1970 merger and had no concern as to what duPont's situation had been as of its most recent audit or in December, 1969. In making this

---

* The application of Section 8(b) was briefed extensively to the Court below and is not being introduced for the first time on this appeal. The repeal of Section 8(b) in 1975 to achieve a uniform administration of ratio under Section 15(c), we submit, does not affect any of the reasoning concerning Congressional policy set forth in our principal brief.

argument, they overlook the fact that by the very act of appropriating $6,000,000 worth of securities of unknown origin into a capital of $18,000,000, duPont had in effect created a continuing falsification of its capital position which affected every capital disclosure and computation made thereafter. Any reasonable person concerned with current capital and the problem of securities differences, as Hirsch, Kohns and Mundheim were, who had been told about the $6,000,000 liquidation of long securities differences would have known that all computations subsequent to December, 1969 had been rendered unreliable.

Frank Gariboldi ("Gariboldi") and Thomas Weil ("Weil"), who investigated on behalf of Hirsch, Kohns and Mundheim, were very concerned with the amount of securities differences disclosed in the duPont operational reports of March, April and May, 1970 and, in particular, with the amount of short securities differences shown in duPont's monthly capital computations. (1682a, 1709a, 1776a) Indeed, they consulted Edward Lill ("Lill") of Haskins & Sells as to whether the effective dates of securities differences from which losses might arise could be identified. (1289a-1290a) Despite their inquiries, Hirsch, Kohns, Mundheim and their investigators were never advised that there had been $6,000,000 long securities differences which had been liquidated in December, 1969 and infused into the general capital of duPont, thereby creating the possibility that duPont's short differences might turn out to be far in excess of those shown on

the March, April and May reports examined by Gariboldi and Weil.*

It is argued that Gariboldi did not attribute any importance to the capital ratio as of the date of the most recent audit since he did not attempt to recompute the capital ratio as of said date from the extensive data supplied in the audited Answers to Financial Questionnaire. Gariboldi testified that he did not consider the capital ratio as of the date of the most recent audit as anything but of historic interest. (1709a) This is understandable. The Statement of Financial Condition and the Answers to Financial Questionnaire of duPont had received unconditional certification from Haskins & Sells, and duPont had never been suspended by the New York Stock Exchange for lack of capital compliance. One would have no reason to suspect that it had been gravely in excess of its permissable capital ratio and, therefore, one would not attempt to recompute the capital ratio, which is a fairly complex task, as of the most recent audit date from the detailed data in the Answers to Financial Questionnaire. Not knowing that duPont's capital ratio had been "cured" by a massive infusion of the proceeds from the sale of securities of unknown ownership, and having no way of finding that out, <u>infra</u>, p. 11 , Gariboldi would have had no cause to question or inquire into the capital ratio in the recent past but would focus on more current data.

---

* It should be noted that although Lill did not mention this problem when questioned by Weil and Gariboldi, he did describe it when questioned about securities differences by a special committee of the New York Stock Exchange shortly after the merger had been consummated, <u>infra</u>, p. 17.

C. The Argument That There Was Nothing Improper About The Liquidation of Long Securities Differences

Haskins & Sells and the New York Stock Exchange have sought to persuade this Court that the actions taken by duPont at the suggestion of the New York Stock Exchange to transform securities of unknown ownership into capital were proper. It is submitted that although the evidence demonstrates that they were highly improper, the issue in the first instance is not one of propriety, but one of materiality. That is, were Hirsch, Kohns and Mundheim entitled to know that $6,000,000 of capital and $2,000,000 of income had been generated in this manner. We believe that the assertion of the propreity of duPont's acts is conclusory and, after examination of the underlying facts, unsupportable. Nowhere, however, do Haskins & Sells and the New York Stock Exchange come to grips with the more important question, should the investors in duPont have been advised of (i) the capital ratio in excess of 76,000%, and (ii) the manner in which this massive capital deficiency was "cured". Hirsch, Kohns and Mundheim were entitled to assume, absent some indication to the contrary, that the capital of duPont was truly proprietary, that is, owned by the firm and shown by its records to be so owned. If the source of $6,000,000 in capital as well as $2,000,000 of income is simply a decision to treat securities in long difference accounts for which another owner cannot be located by a search of the records as capital, Hirsch, Kohns and Mundheim were entitled to be made aware of that fact. This is especially

true when, as Haskins & Sells and the New York Stock Exchange concede, duPont's records and record-keeping were among the worst in the industry. (H&S Br. 12-13, NYSE Br. 8)

The argument is made that the liquidation of long securities differences by duPont during the days following the December 16, 1969 meeting were "entirely proper". (H&S Br. 3; NYSE Br. 24) These statements are belied by the evidence, which demonstrates that the sale of long securities differences by duPont was nothing more than a desperate method for regaining the appearance of capital compliance without regard to possible future consequences.

Initially, both Haskins & Sells and the New York Stock Exchange imply that the securities sold by duPont in December, 1969 were definitely determined to be owned by duPont. (H&S Br. 32; NYSE Br. 30) The evidence demonstrates, however, that duPont had only established, based upon a search of its books and records, that the securities did not appear in the account of one of its customers or some third party. Samuel Gay ("Gay"), who in December, 1969, was the duPont employee in charge of the liquidation, described the "research" involved as follows: (1509a-1510a)

> "Q So what I understand you to say is in addition to going through your own records you would go through customer communications such as complaints, and then you would go through the customer confirmations which the auditors sent out as to which you had gotten responses?"
>
> "A Yes."

"Q This fundamentally, though, was a search through your records and through the auditor's procedures of confirmation and through communications from stockholders and through other records available to you for a claim against a stock which you had in your possession, is that correct?"

"A To try to identify that someone was making a claim for a security that we didn't show him on the record as being owed the security to."

"Q You then concluded that if it is a legitimate long difference, if after doing that kind of a search, you cannot come up with a claim which takes the stock, is that correct?"

"A If you performed all of those steps and identified every one of those items, yes, that is absolutely true."

"Q And so then your position is that if I look through all of these things and I can't find somebody else claiming it, then it is a legitimate long difference?"

"A I would say that's so."

"Q And that was the kind of a difference which you thought you could liquidate?"

"A That's what I felt that Mr. Bishop meant when he talked about liquidating long differences. We should say long security count differences." (Emphasis added)

The purpose of the procedures described by Gay, as suggested by Robert Bishop ("Bishop"), is quite different from research leading to the resolution of differences. Lill testified as follows: (148a)

"Q Is it the purpose of research to try to identify the source of the difference?"

"A Yes, sir."

"Q Is it the purpose of research to try to find the event or transaction which caused the error to occur and thereby adjust the error?"

"A Yes."

Indeed, once the source or cause of the difference is discovered by research, the difference is resolved and the ownership of the security is determined. Gay testified in this regard as follows: (1510a)

"Q At the time of this meeting, December 16th, had there been attempts to resolve these differences on a specific identification basis-- that is to say, to find that specific event or date or transaction which caused the error that gave you the stock?"

"A I don't know whether you are asking me whether what I explained would be the process or a new process."

"Q No, whether some other process was in force or some other process was in operation seeking to find the specific event or transaction to which the stock apparently related."

"A If we had found the specific event we wouldn't have had the difference."

The distinction between the resolution, and thus the elimination, of long securities differences and the liquidation of unresolved differences "researched" in the manner described by Gay is readily apparent. Indeed, Lill could not understand the rationale of Bishop in allowing capital credit for liquidated, unresolved long securities differences and denying such credit

for long securities differences in the first instance which the New York Stock Exchange had absolutely refused to do. (163a, 1219a-1220a)

> "Q Now, can you recall what rationale underlay the difference between liquidating the long difference and helping capital that way and just merely taking a book credit for the long difference?"
>
> "A I cannot. As a matter of fact, I don't understand that there is any substantive difference. Whether or not the long difference is liquidated it's still considered a liquidated, a difference and it's still [researched]."
>
> "Q Was this because you had some reservations about the rationale for the liquidation process, and you wanted it set forth in writing?"
>
> "A I had concern about the firm's status, and their status as interpreted by the regulators, yes."
>
> "MR. CAMHY: Your Honor, I don't think that was responsive to the question I asked, which was whether you had some reservations about the rationale for the liquidation authorization that was in that memorandum."
>
> "A I did have reservation about the rationale. As I indicated, I do not see a substantive difference between getting credit for longs through liquidation or getting credit for longs in a formula computation. The credit can be obtained in either way as long as it is a proper interpretation under the rule."

Of course, there is one distinction. Simply allowing a credit for long security differences would have been contrary

to the well-established rules of the New York Stock Exchange from which it could not deviate. But selling the securities in the long difference account for cash and using the cash to buy in items which were chargeable to capital would accomplish the same result by a means undetectable in the reports. Indeed, it would never have been known but for the discovery procedures in this litigation.

Both the New York Stock Exchange and Haskins & Sells argue that the events of December, 1969 could have been ascertained by comparison of the January 30, 1970 and September 28, 1969 Answers to Financial Questionnaire. (H&S Br. 33-34, NYSE Br. 15-16) However, the January 30, 1970 Answers to Financial Questionnaire does not disclose that long security differences had been "liquidated" rather than resolved. It most certainly did not disclose that the proceeds of the liquidation were used to cure a massive capital deficiency and indeed, to increase net worth. In this regard, Gay testified as follows: (1518a)

> "Q Is there any way you can tell on this questionnaire [January 30, 1970] that six million at least of those differences were sold and went into the general funds of the company to be used to buy up charges against capital and to be added to net worth?"
>
> "A No, you cannot."

Once these actions were taken, their occurrence could not be ascertained without prior knowledge.

It is not disputed by either Haskins & Sells or the

New York Stock Exchange that duPont's basic record-keeping and internal accounting were in a chaotic state in the latter months of 1969. (H&S Br. 12-13, NYSE Br. 8) The nature of the problems being encountered by duPont in these areas, as well as the severity of the problems, are described in letters from Haskins & Sells to duPont, dated September 30, 1968 and November 26, 1969, each entitled "Comments on Conditions referring to the Material and Substantial Inadequacies Found in the Records and Record-Keeping Systems of duPont". (539a-541a, 459a-462a)

Use of the actual entries in records of such poor quality to determine actual ownership in a positive way -- where the records showed that someone owns a given security -- would be difficult enough to justify. Reliance upon <u>the absence of entries</u> in these records -- if there is no entry showing the security to be owned by some one else we can sell it and use the money -- is beyond honest justification. It must be noted that the example of a long security difference -- short security relationship presented by Haskins & Sells (H&S Br. 30-31fn.) is without support in the record. The statement that the long security difference "obviously 'belongs'" to the firm is, of course, the result of the straw man hypothesis presented by Haskins & Sells. There is no indication that the resolution of duPont's long or short securities differences would have such a beneficial result upon the firm. Lill testified that no such relationship between long and short securities differences could be said to exist absent specific <u>resolution</u> by research on an identifiable basis: (147a-148a)

"Q No, I didn't think so. So that if you had differences you would have securities which at least initially, prima facie, don't seem to relate to each other? That is your long differences would be a set of securities which you tried to match to each other and can't?"

"A That is possible. There are relationships. You may have a short difference in General Motors and a long difference in General Electric which ultimately are determined to relate to each other."

"Q Yes, I understand that."

"A By the same token you may have long and short differences that are ultimately determined not to relate to each other."

"Q But prima facie -- that is, starting with the difference which you have not been able to research to an identifiable mistake -- there is no apparent relation between your General Motors over and your General Electric under? They don't offset each other in any way?"

"A Prior to research, no."

"Q Is it the purpose of research to try to identify the source of the difference?"

"A Yes, sir."

As previously stated, the research done by duPont never did identify the source of the differences. The securities were simply sold and the cash used to buy in items that were capital charges, (1393a-1935a) thereby creating capital. Although this was known to Haskins & Sells and the New York Stock Exchange

(1396a) they did nothing about it because it was precisely what had been intended and discussed at the meeting of December 16, 1969.* (567a)

The New York Stock Exchange devotes three pages of its brief to Bishop's testimony as to the suggestions he made at the December 16, 1969 meeting. (NYSE Br. 25-27) At best his recollection is vague other than that he recalls telling duPont to concentrate "research" on the long differences. However, this Court need not rely on Bishop's recollection as other evidence is absolutely clear. Gay's testimony (1509a-1510a) was unequivocal that the procedure to be followed of liquidating long security differences without resolution solely on the basis that the security did not appear in any customer or broker's account was in accordance with the discussion with Bishop and Lill on December 16, 1969. Lill's testimony was similarly clear that the New York Stock Exchange refused to grant capital credit for long security differences as such, but that for some inexplicable reason, Bishop suggested that the same result might be accomplished by simply selling the securities in question and using the proceeds to improve capital by buying in items that were capital charges. Lill did not understand the rationale for this. (1199a)

Finally, Lill's contemporaneous memorandum of the con-

---

* Although, as the New York Stock Exchange asserts that (NYSE Br. 9), there were differing interpretations with respect to some items discussed at the December 16, 1969 meeting (1478a-1482a), Paul Chenet ("Chenet") testified that the treatment of dividends upon fails to receive was never the subject of differing interpretations within the New York Stock Exchange. (1480a) Thus, the 76,000% ratio was not susceptible of argument if the New York Stock Exchange rules were to be followed.

versation leaves absolutely no doubt as to the plan arrived at: (569a-570a)

> "Mr. Bishop then stated that the Exchange would not apply or give credit for such longs in the Rule 325 Capital Computation but Francis I. duPont should avail themselves of the capital benefit of the longs by liquidating the long and short differences or wherever possible, applying in Francis I. duPont's records the long differences and dividends against the short dividends and differences. He said that he strongly recommended that Francis I. duPont undertake such liquidation procedures to improve their poor Rule 325 capital position.
>
> "H&S then agreed with Mr. Bishop's conclusion and, as a further argument in this direction, suggested that the Exchange give consideration to the future problem; namely, the long dividends arising in 1967 and 1968 will be considered under the New York State Escheat Laws as unclaimed property which must be turned over to the state in 1972 and 1973 respectively, and, since many of these long positions represent the results of errors rather than unclaimed property, the Exchange and member firms must develop their theories that they are errors otherwise member firms will be absorbing the actual losses with respect to the short positions and not realizing any of the related gains on the long positions since such long positions will be turned over to New York State. This would be a so-called "one way street" to the disadvantage of member firms and the Exchange.
>
> "The meeting was adjourned with the understanding that Francis I. duPont would proceed to undertake liquidation procedures to improve their capital position. It was clearly understood that there would be a market risk in such liquidation procedures in that a customer or broker may subsequently claim a liquidated position. It was also understood

> that a similar market risk would be present if liquidation procedures were not established in that the unclaimed differences would be held for a year or two before being liquidated."

Lill's memorandum of this part of the conversation makes no mention of "research" whatsoever, least of all to research leading to specific identification of the transactions which were the source of the long security differences. It speaks of "liquidating" the differences or where possible (as in the case of a capital charge and a long difference in the same security) offsetting them even if not otherwise referrable in relation to a particular transaction. The reference in the memorandum to the Escheat Laws and to risk of customer claims leave no doubt that the parties to the conversation knew that their plan was to sell property whose ownership was at best unresolved and to use that property to improve duPont's capital.

It should be recalled that Lill was a hostile witness, being a member of the firm of Haskins & Sells; that Gay was a former executive of duPont who at the time of the trial was a senior executive of the New York Stock Exchange. In the light of these considerations, their testimony and the Lill memorandum must be deemed unimpeachable evidence of what was arranged at that conference. Whatever the propriety of this device as a method of bringing a firm into capital compliance, we respectfully submit that Haskins & Sells and the New York Stock Exchange, having arranged it, were under a duty to disclose what had been done.

The subsequent effect of security count differences upon duPont and its successor F.I. duPont Glore Forgan & Co. ("FIDGF") is well-documented in this record. In August, 1970, Haskins & Sells was requested to perform certain special consultant services for the New York Stock Exchange with respect to FIDGF. (1234a-1235a) Lill testified that one of the critical areas of the consultation was unresolved security count differences. (1235a)

In connection with this consultation, on September 28, 1970, Lill appeared before a special New York Stock Exchange Committee and gave his views about duPont's operational problems. (1235a) The excerpts of Lill's statements before this committee read into the record at trial demonstrate that the problem of security count differences existing at the time of the September 28, 1969 audit continued to exist after the July 2, 1970 merger (1238a-1242a), and that this was much complicated because certain of these differences had been liquidated.

In a memorandum dated October 6, 1970, Charles A. Rubin ("Rubin") of the New York Stock Exchange, after review of the transcripts of the special committee, advised Bishop and Chenet that the treatment of both short security differences and long security differences suggested by duPont and Haskins & Sells should be rejected as it contemplated the further liquidation of long security differences and their offset against short security differences (directly contrary to the procedures prescribed on December 16, 1969).

In letters dated November 3, 1970 and November 4, 1970,

Bishop instructed duPont to begin the sale of capital securities on an immediate basis in order to maintain a $10,000,000 excess capital requirement. (534a, 535a)

On November 25, 1970, Haskins & Sells reported upon the audit of FIDGF as of September 27, 1970 and included therein a reserve for possible losses in connection with security count differences in the amount of $15,500,000. (429a) Indeed, Haskins & Sells' opinion upon the FIDGF Answers to Financial Questionnaire as of September 27, 1970 was expressly made subject to the ultimate disposition of unresolved security differences. (420a)

In a letter dated November 25, 1970 to FIDGF, Haskins & Sells, in reporting upon the material inadequacies in FIDGF's accounting system and internal accounting control, stated that there were substantial amounts of securities differences and (464a)

> "Although most of these differences were discovered in 1970, many appear to have originated in 1969 as a result of inadequate controls over securities in transfer 1969."

On November 24, 1970, as a result of preliminary indications from Haskins & Sells of the results of its audit of FIDGF, Bishop wrote to FIDGF and required the sale of all securities remaining in capital accounts, including subordinated accounts and firm positions of any nature whatsoever. (536a)

Finally, Haskins & Sells reported in connection with the audit of FIDGF as of April 30, 1971 that reserves in the amount of $42,000,000 had been established for possible losses in connec-

tion with security count differences. (553a) As previously stated, as a result of the April 30, 1971 audit, Hirsch, Kohns and Mundheim were informed that their investments in duPont had been exhausted as of December 31, 1970. It is clear that the security count differences played a major role in the demise of duPont and the elimination of the capital investments of Hirsch, Kohns and Mundheim, and these differences dated back to the audit of September, 1969 and were concealed and exacubated by the scheme of December 16, 1969 to liquidate them and use the proceeds to create the appearance of capital.

POINT II

HASKINS & SELLS AND THE NEW YORK STOCK EXCHANGE HAD A DUTY TO DISCLOSE THE FACTS

A. The Effect Upon The September 28, 1969 Financial Statements of duPont Certified by Haskins & Sells

Haskins & Sells repeatedly argue that plaintiffs did not prove that any figures set forth in the September 28, 1969 financial statements of duPont were erroneous. (H&S Br. 21, 39) It is submitted that if duPont's capital ratio was far in excess of the permitted capital ratio on its audit date, then virtually all of entries in the Statement of Financial Condition certified by Haskins & Sells (391a) were false since it reflected assets and liabilities on a "going concern" basis and not at values reflecting the forced liquidation and suspension of operations which should be required of a firm massively out of capital compliance.*

It has been demonstrated that the duPont capital deficiency as of September 28, 1969 was <u>not</u> cured as of November 26, 1969, the date of Haskins & Sells' audit report because of the New York Stock Exchange requirement that dividends on securities fail to receive in excess of $8,000,000 be charged against capital.

---

* At the trial Judge Carter observed that the financial implications of being out of ratio was self-evident. (1140a-1141a) An example of the effect of an out of ratio condition is shown in the letters written by Bishop to duPont the following year when the New York Stock Exchange demanded that the firm proceed forthwith to liquidate all of its capital positions in order to bring itself into ratio. (536a)

Indeed, the capital deficiency was astronomically greater than initially determined by Haskins & Sells as of September 28, 1969. (Compare 470a-471a with 451a-452a)

The effect of such a capital deficiency upon financial statements, such as duPont's, prepared on a "going concern" basis was described by the Committee on Stockbrokerage Auditing of the American Institute of Certified Public Accountants, which included Lill, in "Audits of Brokers and Dealers in Securities" as follows: (960a)

> "There may be situations where it is appropriate for the independent public accountant to qualify or disclaim an opinion. Particularly troublesome areas include material amounts of unresolved securities differences, suspense accounts, unverified transfer items and unverified dividends receivable. Situations may also be encountered where operational conditions and the status of the records are such that it would be inappropriate to report on financial statements prepared on a 'going concern' basis."
>
> "A violation of the applicable net capital rules as of the audit date requires footnote disclosure and may require the independent public accountant to qualify his opinion because of 'going concern' considerations. However, there may be situations in which the capital deficiency is corrected prior to the issuance of the independent public accountant's report. In these circumstances footnote disclosure may be adequate."

Although this industry audit guide was published in 1973, Lill, who was one of its authors, testified that the principles des-

cribed above were equally applicable in the final months of 1969. (2189a-2191a)

Notwithstanding the foregoing rule, the capital violation of duPont as of its audit date discovered by Haskins & Sells and cured by the input of additional capital prior to the issuance of Haskins & Sells' report did not result in the qualification of that audit report nor did it receive footnote disclosure in duPont's published financial statements.* More importantly, Haskins & Sells made no attempt to disclose the massive capital violation as of the audit date disclosed by the New York Stock Exchange's correction of their computation made known to them in December, 1969. Furthermore, Haskins & Sells made no attempt to ascertain the validity of the "cure" by means of the liquidation of unresolved long security differences. The importance of disclosing a capital violation, even if "cured" and of verifying the validity of the cure are evidenced from Lill's prior testimony as to the vigilance exercised by Haskins & Sells with respect to cure of the smaller capital violation which they had discovered earlier. (2194a)

> "Q Would you have issued a clean opinion, that is the opinion that went to the public, would you have issued that opinion if that capital had not come in?"

---

* Although this capital violation and its cure were disclosed in a Memorandum of Net Capital Computation prepared by Haskins & Sells and delivered (after request) to the Securities and Exchange Commission, that Memorandum was <u>not</u> publicly disseminated.

"A I would have considered all of the attending circumstances but I did not face the question at the time."

"Q Well, my question is if that capital had not been received would you have issued the opinion?"

"A Probably not, although it is very difficult to answer because I would have then had the obligation to go further into the discovery of this going concern question."

"Q And did you consider it your job and your professional obligation to satisfy yourself that the capital did come in and not merely being told that it had come in?"

"A Yes. As a matter of fact I believe a letter report was issued to that extent."

Indeed, Lill viewed the post-audit date cure of a capital violation as a material event requiring disclosure, testifying as follows: (170a)

"Q If one were to follow your theory you couldn't have had to bother with that, would you? You could simply tell the world or the exchange so much has happened since that date it doesn't matter. But you went to the trouble of putting the two things on to show the six million had been made good?"

"A They were significant subsequent events."

The liability of an accountant for failure to disclose significant post-audit events is discussed at length in the

initial brief of Hirsch, Kohns and Mundheim and will not be repeated here. In the instant case, Lill conceded (i) that capital violations affected going concern value, and (ii) that the cure of capital violations should be verified if certification is to be given. How then can Haskins & Sells argue that the subsequent discovery by Haskins & Sells that the New York Stock Exchange found the capital violation to be much larger than originally believed by Haskins & Sells and that it remained uncured did not require withdrawal or qualification of the Haskins & Sells' opinion or other appropriate disclosure? If Haskins & Sells was not going to withdraw or qualify its opinion, wasn't it at least required to satisfy itself that the deficiency was cured with the same vigilence as it exercised as to the smaller deficiency?

Given Haskins & Sells' appreciation of duPont's record keeping problems (459a) could it stand by silently while duPont proceeded to "cure" the capital deficiency with the proceeds of long securities differences arising from duPont's record keeping inadequacies? We submit that the answer to the foregoing questions is in the negative.

B. <u>The Duty of the New York Stock Exchange to Disclose</u>

In considering whether the New York Stock Exchange was under any duty of disclosure, it should be remembered that through its constituent member firms, the New York Stock Exchange had a

huge financial stake in the continued operation of duPont. The demise of duPont prior to the merger on July 2, 1970 or in December of 1970 when it was again reorganized would have had a domino effect which would have imperiled the New York Stock Exchange and its other members. Indeed, as Lee Arning ("Arning") of the New York Stock Exchange testified, the New York Stock Exchange, through its Trust Fund and other mechanisms, had expended approximately $84,000,000 in satisfying claims against member firms which had failed during this period. (1564a-1565a) There was, therefore, commercial self-interest on the part of the New York Stock Exchange to conceal duPont's true condition in order to keep the firm operational. In these circumstances, the New York Stock Exchange isn't in the position of the disinterested regulator to disclaim a duty of disclosure. It benefited from the non-disclosure.

POINT III

THE INVESTMENT AND THE DAMAGES SUFFERED BY PLAINTIFFS WERE PROVEN

Both Haskins & Sells and the New York Stock Exchange have belatedly challenged the investment made by Hirsch, Kohns and Mundheim. (H&S Br. 44-45, NYSE Br. 44) Specifically, it is argued that the value of the investments of Hirsch, Kohns and Mundheim representing their respective proportionate shares of the net asset value of the assets and liabilities of Hirsch & Co. transferred to duPont was not proven.

The investment by Hirsch, Kohns and Mundheim in duPont was handled administratively by Alexander Norman ("Norman"). (1619a) The sole purpose of the direct examination of Norman during the trial of this action was to prove that investments were made by Hirsch, Kohns and Mundheim in duPont. As a portion of this investment was made by means of duPont's crediting the respective capital accounts of Hirsch, Kohns and Mundheim with their proportionate shares of the net asset value of the assets and liabilities of Hirsch & Co. transferred to duPont, Norman was asked upon direct examination to describe the procedures by which the designated assets and liabilities of Hirsch & Co. were transferred to duPont. (1608a) Norman was permitted to testify as to the transfer of these assets and liabilities despite the objections of counsel for Haskins & Sells. (1609a-1611a) Norman

testified that there was a net asset value, and he testified as to its amount. (1611a-1612a) At that time, there was offered for admission into evidence a computer listing of each asset and each liability and the values thereof which had been transferred from Hirsch & Co. to duPont. Counsel for Haskins & Sells objected to the introduction of the entire computer run into evidence. (1612a-1613a) The Court accepted into evidence one page of the computer run containing a summarization of the values of the assets and liabilities and the net transferred value. (1615a) Norman then testified as to the apportionment of the net transfer value among the capital accounts of Hirsch, Kohns and Mundheim at duPont. (1618a) In objecting to the introduction of an exhibit demonstrating the apportionment, counsel for Haskins & Sells stated: (1618a)

> "I don't see what purpose this serves by putting in exhibits of this sort. <u>We will stipulate to the figures</u>. <u>There is no dispute in the case as to the amount of credit that was given to these plaintiffs</u>." (Emphasis added)

Norman also testified as to the portion of the investments of Hirsch, Kohns and Mundheim made in cash. Once again, counsel for Haskins & Sells objected to the introduction of exhibits demonstrating the transmission of funds to duPont by Hirsch, Kohns and Mundheim. (1621a) In so doing, counsel for Haskins & Sells stated: (1621a)

> "Your Honor we can stipulate to the three figures here. I don't think we need the checks and the transmittal

letter. <u>There is no issue in the case with respect to the amount of money that the plaintiffs invested in this firm</u>." (Emphasis added)

It is apparent from the statements made by counsel for Haskins & Sells and the stipulations agreed to during the course of Norman's direct testimony (1607a-1621a) that there was no dispute at the trial as to the value of the investments made by Hirsch, Kohns and Mundheim. Indeed, it was urged by counsel for Haskins & Sells that the introduction of detailed computer listings of the assets and liabilities and the values thereof into evidence was unnecessary surplusage. At no time during the cross-examination of Norman were the values attributed to the assets and liabilities of Hirsch & Co. transferred to duPont <u>challenged</u>. Under these circumstances, Hirsch, Kohns and Mundheim must be said to have established a prima facie case as to the value of their investments in duPont. If Haskins & Sells and the New York Stock Exchange believed that the values introduced into evidence and indeed, stipulated to, were incorrect, it was their burden to present contrary evidence. No such evidence was presented.

The New York Stock Exchange and Haskins & Sells have also argued that Hirsch, Kohns and Mundheim "reinvested" their funds in FIDGF in December, 1970 and therefore suffered no damage as a result of their initial investment. (H&S Br. 19-20, 43-44, NYSE Br. 19-20, 44) The evidence demonstrates, however, that the "reinvestment" was far from a wilful, voluntary act.

Although Hirsch, Kohns and Mundheim attempted to withdraw their capital from FIDGF upon learning of its perilous financial and operational conditions (904a-905a, 906a-907a, 1817a), they were effectively prevented from doing so by H. Ross Perot and his associates ("Perot Group") in conjunction with the New York Stock Exchange. Hirsch, Kohns and Mundheim were bluntly told at a meeting in December, 1970, attended by Robert Haack ("Haack") and Bernard Lasker ("Lasker") of the New York Stock Exchange and others, that their capital could not be withdrawn because there were no funds available to duPont at that time in the absence of the proposed investment by the Perot Group. Hirsch, Kohns and Mundheim were also informed at this meeting that the Perot Group would not make its investment in duPont if Hirsch, Kohns and Mundheim attempted to withdraw their capital. (2053a-2054a) To argue, as the New York Stock Exchange has done, that the "reinvestment" of Hirsch, Kohns and Mundheim was voluntary and wilful is incredible in view of the fact that senior officers of the New York Stock Exchange made it clear to Hirsch, Kohns and Mundheim in December, 1970 that their money could not be withdrawn.

In addition to being effectively precluded from withdrawing their capital from FIDGF in December, 1970, Hirsch, Kohns and Mundheim were advised in October and November of 1971 that the results of the recently completed audit of FIDGF conducted by Haskins & Sells as of April 30, 1970 made it clear that as of December 31, 1970, there was no general partnership capital in duPont and that the limited partnership capital had been at least

substantially impaired, if not totally eliminated. (386a-387a, 388a-390a) Under these circumstances, the activities of Hirsch, Kohns and Mundheim in December, 1970 must be viewed not as a "reinvestment" but as an attempt to salvage what little they could of their investment in duPont.

POINT IV

THE FINANCIAL CONDITION OF HIRSCH & CO.

Both Haskins & Sells and the New York Stock Exchange have gone to great lengths to portray Hirsch & Co. as being in a perilous financial condition during the first six months of 1970. (H&S Br. 2, 6-8, NYSE Br. 5-7) The conclusion which Haskins & Sells and the New York Stock Exchange would have this Court draw from this discussion is that Hirsch, Kohns and Mundheim were desperate to merge Hirsch & Co. with duPont in order to avoid financial calamity.

Simply stated, there is nothing in the record indicating that Hirsch & Co. was insolvent or on the brink of bankruptcy as Haskins & Sells would lead this Court to believe. (H&S Br. 2) Initially, both Kohns and Mundheim testified that the merger was only one of the alternatives which they believed could resolve the financial and operational problems which Hirsch & Co. had encountered in 1969. (1803a, 2073a) Furthermore, it is clear that there were reasons for the merger beyond the respective financial conditions of duPont and Hirsch & Co. (2023a-2024a)

Finally, the recitation by the New York Stock Exchange of the regulatory problems facing Hirsch & Co. in 1969 and early 1970 served only to demonstrate their insignificance in comparison with the massive problems and irregularities occurring at duPont. It simply cannot be suggested that Hirsch & Co. was on the brink

of bankruptcy because its capital ratio reached 1,715% in February, 1970 when at the same time the New York Stock Exchange seeks to minimize the capital ratio at duPont which exceeded 76,000%. If it is believed that Hirsch & Co. was insolvent and desperate for a merger because of the facts recited by the New York Stock Exchange and Haskins & Sells, it must be recognized that duPont's financial condition required the suspension of the firm in December, 1970.

CONCLUSION

For the foregoing reasons, the judgment of the Court below should be reversed.

Respectfully Submitted,

SHEA GOULD CLIMENKO & CASEY
Attorneys for Plaintiffs-
Appellants Howard C. Hirsch,
Paul L. Kohns and Marshall
S. Mundheim
330 Madison Avenue
New York, New York 10017
(212) 661-3200

Of Counsel:

Sheldon D. Camhy
Richard L. Spinogatti

A 202 Affidavit of Personal Service of Papers LUTZ APPELLATE PRINTERS, INC.

COURT OF APPEALS
SECOND CIRCUIT

HOWARD C. HIRSCH, PAUL L. KOHNS and MARSHALL S. MUNDHEIM,
Plaintiffs-Appellants,

- against -

EDMOND duPONT, WALLACE C. LATOUR, MILTON A. SPEICHER, FRANCIS I duPONT & CO., FI duPONT GLORE FORGAN & CO. AND DUPONT GLORE FORGAN INC.,
Defendants
and
HASKINS & SELLS AND THE N.Y. STOCK EXCHANGE, INC.
Defendants-Appellees.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

I, Reuben A. Shearer *being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at* 211 West 144th Street, New York, New York 10030

That on the 17th *day of* January, 1977 *at* 1, 80 Pine St.; New York, N.Y.
2, I Chase Manhattan Plaza, New York, N.Y.

deponent served the annexed Reply Brief *upon*
1, David Hyde, Esq.
2, Russell Brooks, Esq.

the *in this action by delivering a true copies thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the* *herein,*

Sworn to before me, this 17th
day of January, 1977

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1977

Reuben Shearer

Reuben Shearer